Armenia

Rapidly rising per capita incomes and falling poverty rates abetted by well-sequenced economic reforms are the country's current hallmarks. A systematic reduction in the fiscal deficit has been accompanied by a narrowing current account deficit. Following average growth of about 12% over 2001–2004, gross domestic product grew by about 14% in 2005 owing to substantial construction activities and a good harvest. The year also saw increases in public expenditure, remittances, and investment, which boosted domestic demand. Inflation was only 0.6%, aided by exchange rate appreciation and a tight monetary policy. Over the next 2 years, growth is likely to slow somewhat as the pace of construction slackens. Medium-term prospects are broadly favorable if economic reform momentum is sustained. Prospects would brighten considerably if an agreement to resolve the conflict over Nagorno-Karabakh were concluded favorably and if Armenia's borders with Azerbaijan and Turkey were reopened to trade.

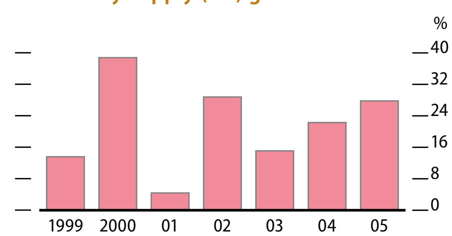
Economic performance

Armenia continued along its double-digit growth path in 2005, as it had for several years. Per capita GDP in United States (US) dollars has shown a significant and consistent increase from $592 in 2000 to $1,107 in 2004 and further to an estimated $1,513 in 2005. The growth of gross domestic product (GDP) was almost 14% in 2005, driven by the fast-growing construction sector and a solid agricultural performance. Booming construction activities, reflecting new investment in housing and industries such as mining and energy, were important elements. Growth in construction reached 35.1% against a relatively modest 13.4% in 2004, though that in other services such as trade, and transport and communications, slackened. With improved market access and a good crop of cereals, fruit, and vegetables helped by favorable weather conditions, agricultural output grew by 11.2%. After a slowdown to a mere 7.2% in 2004 from double-digit rates in 2002–2003, industrial growth picked up to 7.4% in 2005. This is attributable to a solid performance of the energy sector as well as machine-building, metallurgy, and electrical industries, which outweighed a poor performance in mining and agroprocessing.

Structural and institutional reforms, implementation of a poverty-reduction strategy from 2002, and strong growth brought down poverty from 55% in 1996 to 39% in 2004. Extreme poverty fell from 27.7% to 7.2% over this period. The official unemployment rate also fell, from 10.1% in 2003 to 9.6% in 2004 and further to 8.1% in 2005; however, it may understate labor market problems (as discussed below).

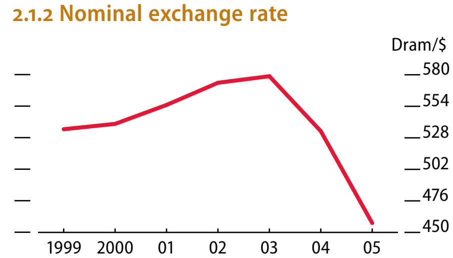
The Central Bank of Armenia maintained its anti-inflation stance in 2005. Having reached 4.7% and 7.0% in 2003 and 2004, inflation fell to just 0.6% in 2005, well below the target of 3.0%, and the 3.0% average in 2000–2004. Exchange rate appreciation, tight monetary policy, prudent fiscal policy, and a good agricultural harvest helped lower inflation. Over the medium term, the central bank will shift toward a

2.1.1 Money supply (M2) growth



Source: Central Bank of Armenia, available: http://www.cba.am/publications/indicat/economic.xls, downloaded 20 March 2006.

2.1.2 Nominal exchange rate



Source: Central Bank of Armenia, available: http://www.cba.am/publications/indicat/economic.xls, downloaded 20 March 2006.

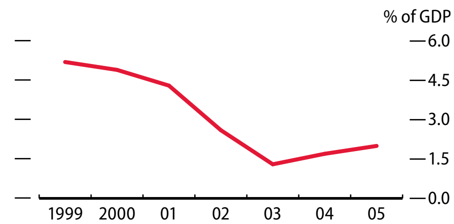
monetary policy framework based on inflation targeting. Broad money growth (Figure 2.1.1) reflected higher demand for money as a result of slowly improving confidence in the banking system. Rapidly growing remittances and a strengthening of the capital and financial account led to an appreciation of the domestic currency, the dram, by 16.6% between 2004 and 2005 (Figure 2.1.2). There are fears that the dram's appreciation may erode the country's competitive advantage. A new law that requires certain transactions to be conducted only in drams, as part of the Government's drive toward de-dollarization of the economy, as well as the dram's appreciation, has increased demand for the local currency.

Fiscal consolidation has been a crucial element of the Government's solid macroeconomic management of the economy. In 2000–2004, the fiscal position improved markedly with the overall central government budget deficit falling from 5.2% of GDP in 1999 to 1.7% in 2004 (Figure 2.1.3). Preliminary estimates for 2005 indicate a deficit of about 2% of GDP against the originally programmed 2.9%. This is primarily attributable to lower than planned capital expenditure, stemming from credit disbursement delays and procurement constraints. However, although budget deficits are now lower, both revenue and expenditure present problems. Revenue mobilization, though picking up slowly, has been limited for several reasons including low tax buoyancy, tax exemptions and tax holidays, administrative weaknesses adding to tax arrears, and low tax rates. In line with the ongoing structural reforms, the Government has proposed streamlining the tax system, and tax and customs procedures include widening the tax base, reducing tax evasion, improving tax audits, abolishing exemption to grant-financed construction and to tax holidays for new foreign investors, and installing computerized information systems. On the expenditure side, the reforms will cover better budgeting procedures and expenditure management. In an attempt to enhance the quality of public spending, the Government plans to include a public investment program in its 2006–2008 Medium-Term Expenditure Framework.

The Government is following a sound debt-management strategy with close coordination between its macroeconomic and external debt-management policies. Prioritized use of concessional external assistance and grants has led to a systematic reduction in public debt ratios. Debt management remained on track in 2005 as debt continued to fall steadily from 47% in 1999 to 23% in 2005, partly reflecting a debt-for-equity swap with the Russian Federation (Figure 2.1.4). According to a joint International Monetary Fund-World Bank analysis, all external public debt indicators for the country are sustainable and below the relevant country-specific debt-burden thresholds. Armenia is classified as at low risk of debt distress.

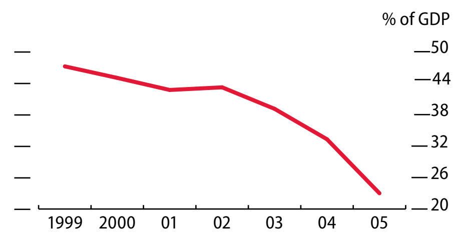
Foreign trade turnover grew rapidly and the current account strengthened in 2005. Exports grew by 28.2% and imports 23.8%. Precious stones and base metals were the two major export items (about 70% of the total). Metallurgy has benefited from an increase in foreign investment in recent years, enabling it to sharply lift exports in 2005 to equal those of the diamond-polishing trade. Exports of food items also jumped. The trade deficit fell by more than half, from about 26% of GDP in 1999 to about 11% in 2005, and with strong growth in current transfers, including

2.1.3 Budget deficit



Sources: National Statistical Services of the Republic of Armenia, available: http://www.armstat.am/Arm/Publications, downloaded 10 February 2006; Ministry of Finance and Economy.

2.1.4 External debt

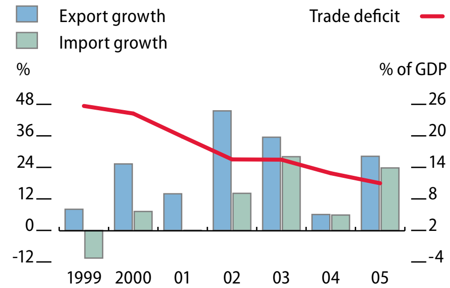


Source: National Statistical Services of the Republic of Armenia, available: http://www.armstat.am/StatData, downloaded 10 February 2006.

greater remittances from workers abroad, the current account deficit also narrowed substantially (Figure 2.1.5). In 2005, it fell to 3.1% of GDP, compared with an average of 8.3% in the preceding 5 years.

Ongoing strengthening of the business regulatory environment, remittances from the Armenian diaspora, a well-educated but relatively low-cost labor force, and noninterventionist trade policies have fostered greater investment in recent years. Still, the economy still faces many structural bottlenecks. Productivity and private sector wages have risen sharply, but employment growth has been much less pronounced, especially outside Yerevan; and though employment in foreign-invested sectors has risen, aggregate employment has stagnated. Unofficial estimates put unemployment at close to 30%. The lack of employment opportunities has led to substantial emigration of workers, and many of those left rely on remittances. To help tackle the problem, a new Labor Code, in line with the requirements of a market economy, was adopted by Parliament in November 2004.

2.1.5 Trade indicators



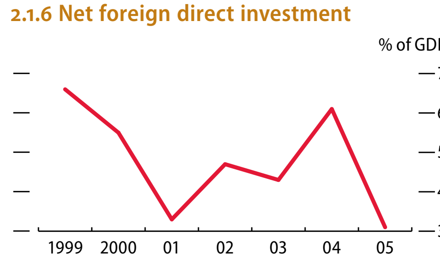
Source: Central Bank of Armenia.

The key constraints to fair competition and to larger inflows of foreign direct investment (FDI) are the unfavorable domestic environment for entry and exit of firms and their limited capacity to recover debts. The private sector has to deal with corruption, favoritism, and an underdeveloped legal system. Banking has been strengthened through regulation, privatization, and consolidation, though it continues to suffer from inefficiencies, weak risk management, and high lending risk. The nonbank financial services market remains underdeveloped. In this context, the Government is seeking to address issues such as an underdeveloped market infrastructure, weak corporate governance, and lack of competition in the banking sector through its economic program with the International Monetary Fund. Elsewhere, it will continue to cut subsidies and raise tariffs for the power and water utilities.

The Government is creating an independent regulatory oversight agency for most sectors. It is also designing policies to strengthen the regulatory and legal environment, the judicial system, and the rule of law, while improving tendering procedures.

Armenia has attracted significant levels of domestic and foreign investment in the past few years. The majority of private financing comes from FDI, which largely originates in the diaspora. FDI averaged 5% of GDP in 2000–2004 (as against 4% in the rest of the Commonwealth of Independent States) though in 2005 it was somewhat lower than in the earlier period (Figure 2.1.6). Pursuing ongoing reforms in an open-trade policy regime, a well-developed trade facilitation system, a favorable behind-the-border business environment, a modernized tax and customs administration, appropriate services such as transport and communications, and related border infrastructure that facilitates exports and imports are all critical to attract more FDI.

2.1.6 Net foreign direct investment



Source: Central Bank of Armenia.

Economic outlook

The structural and institutional reforms are expected to continue over the medium term. In particular, current developments show that the Medium-Term Expenditure Framework (2006–2008) is on track and the Government is likely to keep improving its revenue performance and expenditure targeting in line with its Poverty Reduction Strategy Paper. It is assumed that the exchange rate against the US dollar will stabilize at the current level, that exporters will face lower global commodity prices in 2006 for products such as metals, but that high world oil prices will persist. There is also a chance that the Russian Federation will implement its plans to phase out its heavy subsidies on gas to the country (a legacy of the Soviet era).

The overall economic outlook is positive. The growth momentum built up in recent years will continue into 2006 but perhaps at a slower pace given that the base-period growth was strong. As the boom in construction activities slows, aggregate growth will slip to somewhere between 6.0% and 7.5% over the 2006–2007 forecast period (Figure 2.1.7). Per capita GDP is expected to continue rising, given a fairly stable population of about 3.2 million. Preliminary estimates suggest that income will exceed $1,600 by 2006 and rise to over $1,700 by 2007. Strong growth in government consumption and investment, as the authorities increase both social and capital spending, will provide a favorable outlook for domestic demand. In keeping with the 19.5% increase in dram-denominated average monthly nominal wages in 2005, further wage rises—along with continued strong inflows of workers' remittances—should support private consumption and domestic demand.

An escalation in the cost of imported energy is expected to put pressure on inflation, which is projected at an annual rate of 3.0% in 2006 and 2007 (Figure 2.1.8). Uncertainty about money demand in light of official efforts to encourage the use of domestic rather than foreign currency, given its appreciation, will require both vigilance and flexibility on the authorities' part in setting monetary policy if target inflation is to be achieved. Although not predicted, any further appreciation of the dram against the US dollar would help subdue the inflationary impacts of higher oil prices.

The Government has programmed a budget deficit of 2.9% of GDP in 2006 and 2007 to accommodate a sharp rise in spending on social programs and infrastructure, in line with the targets in the Poverty Reduction Strategy Paper. The 2006 state budget has increased spending on infrastructure, health, education, and social protection in addition to granting a higher allocation to public sector salaries and pensions. To keep the fiscal deficit within target, revenue collection will need to strengthen considerably, based on improvements in tax compliance and administration, and tax and customs reform.

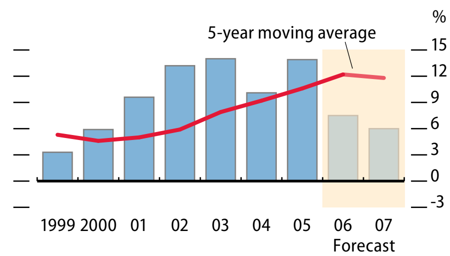
If the trends of the last few years are maintained, increases in net income from abroad and foreign transfers are expected to offset the growth in the trade deficit and contain the current account deficit to a little over 4% of GDP in the medium term. The proceeds from the proposed sale of Armenia's electricity distribution company to Interenergo, a subsidiary of the Russian company Unified Energy Systems, as well as continued inflows of foreign grants and concessional assistance, are expected to continue financing the current account deficit and provide for a moderate increase in official reserves. A large $235 million grant under a 5-year Compact with the Millennium Challenge Corporation of the US will be spent mainly on upgrading rural infrastructure, ultimately to reduce poverty.

2.1.1 Selected economic indicators

	2006	2007
GDP growth	7.5	6.0
Inflation	3.0	3.0
Current account balance (% of GDP)	-4.1	-4.3

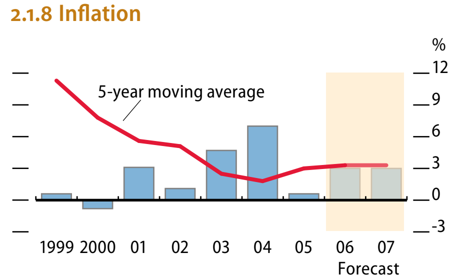
Source: Staff estimates.

2.1.7 GDP growth



Source: National Statistical Services of the Republic of Armenia, available: http://www.armstat.am/Arm/Publications, downloaded 10 February 2006.

2.1.8 Inflation



Source: National Statistical Services of the Republic of Armenia, available: http://www.armstat.am/Arm/Publications, downloaded 10 February 2006.

Despite a projected slowdown in growth in 2006–2007, the medium-term outlook is broadly favorable on the basis of further improvements in infrastructure, institutions, and governance. Prospects, however, would be significantly better if an agreement to resolve the conflict with Azerbaijan over Nagorno-Karabakh was concluded. This would allow Armenia's closed borders with Azerbaijan and Turkey to reopen, providing "land-bridge" opportunities that should significantly boost growth in trade, investment, and the economy generally. In February 2006, the leaders of the two sides met, though they failed to reach agreement on a framework to resolve the issue.

Armenia's reliance on a narrow export basket is a risk to growth because of its vulnerability to a slump in global prices for these commodities. A large volume of food imports and a narrow manufacturing base are other key weaknesses. There is also a potential risk of considerably higher imported gas prices if subsidies are ended, which would push inflation up and drag growth down. Moreover, the country remains vulnerable to devastating natural disasters such as the 1988 Spitak earthquake, which continues to have an economic impact.

Behind-the-border barriers to trade

In keeping with its liberal trade outlook, Armenia joined the World Trade Organization (WTO) in 2003 and has reduced tariffs and eliminated quotas (Table 2.1.2). Even so, trade suffers from significant behind-the-border barriers. These include (i) administrative barriers that delay shipments, such as border procedures involving tax documents and signatures for border clearance, and customs and cargo inspections; (ii) technical barriers to compliance with the WTO Code of Good Practice, such as harmonized technical regulations, international standardization processes and infrastructure, and changes to bilateral agreements (mostly within the Commonwealth of Independent States); and (iii) physical barriers such as inadequate inland transport and trade infrastructure, including roads, and border and warehousing facilities. In fact, poor roads and other infrastructure account for only a small part of the delay in taking goods from the factory gate to the border. The rest is explained by the administrative and technical hurdles. Recent studies have shown that regional integration of the economy, which would entail removing such barriers, lifting trade blockades, and improving transport networks, could increase the country's trade by 30–50% and its GDP by 30%.

2.1.2 Index of trade restrictiveness

Region/Country	1997	2004
Armenia	1.0	1.0
Commonwealth of Independent States average	3.7	2.6
Developing countries	5.1	4.0

Note: The index reflects both tariff and nontariff barriers and ranges from 1 (most liberal) to 10 (highly restrictive).

Source: International Monetary Fund. 2005. *Growth and Poverty Reduction in Armenia: Achievements and Challenges*.